AT&T claims, finally, that there is no evidence to support a contention that actual lives are shorter than the lives prescribed by regulators. Indeed, says AT&T, the embedded costs of some plant may be less than its forward-looking costs. If these assertions are true, the answer is to give the ILECs an opportunity to prove their case. They do not justify simply denying recovery out of hand. Moreover, in a competitive market, depreciation lives are not set based on how long a piece of equipment could conceivably remain in place before disintegrating. Competitive depreciation lives, such as those used by AT&T, recognize that competitive market forces require new investment and they are set to facilitate the implementation of technological advances.

On the revenue side, AT&T first contends that the ILECs may be able to recover nearly all of their embedded costs (up to $4 billion) from the new universal service fund and by reallocating certain costs (some $5.3 billion) to their cost causers -- end users. But this would require allocating the entire universal service fund to interstate services, as well as a significant increase in the charges to end users -- both unlikely prospects. In any event, AT&T misses the point: access prices cannot be reduced other than in tandem with rate rebalancing. AT&T would reduce prices in the hope that something else might be done to compensate the ILECs. Although AT&T is free to advocate this, the Commission cannot adopt such an approach.

But even if these revenue sources do not become available, the ILECs have no cause to worry, says AT&T, because they have available to them as much as $31 billion in additional revenues -- and no less than $19.4 billion.[26] More than half of this amount -- $11 to $18 billion -- comes from interLATA service, based on an assumption that the ILECs will capture some 15 to 25% of the interLATA market. But that assumes quick BOC entry into the interLATA business, an eventuality that AT&T will oppose with every resource at its command. More important, it assumes the ILECs can garner all this revenue with no increase in their costs. The highly competitive interexchange business surely will not allow the ILECs to earn "supracompetitive" margins.

The other "new" revenue sources are not new at all. They are existing services, most of which are regulated. They provide the ILECs no opportunity to capture additional revenues to defray the "shortfall" (see Section III.B, infra.).

III. THE COMMISSION MUST PROVIDE FOR FULL RECOVERY OF INTERSTATE COSTS UNDER ANY NEW ACCESS RATE STRUCTURE (NOTICE SECTION VII)

In its Comments, U S WEST demonstrated that the Commission is obligated to revise the access rate structure so that U S WEST and other ILECs are able to recover the costs of interstate access operations, including investment related thereto, plus earn a reasonable profit. The Commission must adopt rules which permit full recovery of the legitimate costs associated with access which were identified by U S WEST in its Comments. In contrast, MCI and AT&T would have U S WEST, as well as other ILECs, be forced by edict to forego recovery, apparently based on the premise that, notwithstanding the impending imposition of certain

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[26] See AT&T, App. B (Kravtin and Selwyn) at 17 and 20-25.

access rates upon ILECs, competition in the telecommunications market does not entitle ILECs to recover their prudent investments and, in any case, will prevent ILECs from suffering any losses.

MCI and AT&T state that bringing down access charges to forward-looking economic costs without concomitant rebalancing would not constitute an unconstitutional taking of property.[27] In fact, to the extent that such regulatory action would prevent U S WEST from recovering the full amount of its prudently made investment and its actual operating costs, a violation of the Fifth Amendment Takings Clause would result. If the Commission intends to require U S WEST to charge a certain price for access services which does not fully recover U S WEST's full costs -- and the Notice makes it appear that the Commission is leaning in this direction -- the Commission is obligated to simultaneously adopt a mechanism which provides an opportunity for full recovery. This cost recovery could be based on universal service funding, rate rebalancing (including separations reform), or straight-out government compensation. Our point is, the Commission may not simply drive costs out of ILEC business operations without taking steps to permit reasonable recovery of those costs.

A. The Public Interest Does Not Justify Access Rates Which Do Not Provide U S WEST Full Cost Recovery (Notice Section VII)

In support of its claim that a taking will not result if ILEC costs are set by the Commission without regard to actual cost and investment, MCI appears to contend that the public interest in these companies having reduced access rates

[27] MCI at 29; AT&T at 39.

outweighs any loss ILECs will experience.[28] Even if true, this argument is irrelevant. When property is taken for public benefit, just compensation must be paid. An uncompensated seizure does not become lawful because it was well motivated. The Supreme Court in Northern Pacific Railway profoundly diverges from the thinking of MCI and AT&T. It found that a state could not justify an unreasonable railway rate on the basis that the people of the state would benefit:

> [W]hile local interests serve as a motive for enforcing reasonable rates, it would be a very different matter to say that the State may compel the carrier to maintain a rate upon a particular commodity that is less than reasonable, or -- as might equally well be asserted -- to carry gratuitously, in order to build up a local enterprise. That would be to go outside the carrier's undertaking, and outside the field of reasonable supervision of the conduct of its business, and would be equivalent to an appropriation of the property to public uses upon terms to which the carrier had in no way agreed.[29]

In trying to serve the public interest, the Commission may not use that goal to impose access prices that prevent U S WEST from properly conducting its business.

B. Full Recovery For Access Services Must Be Provided Through The Access Rate Structure; Other Sources of Revenue Cannot Make Up For Any Disparity In Charges Set By the Commission and Actual Costs, Nor Can Recovery Be Transferred to Another Jurisdiction (Notice Section VII)

MCI also claims that reducing access charges cannot constitute a taking under the Fifth Amendment because Congress has created new opportunities for ILECs to use their facilities to provide new services (e.g., long distance pursuant to Section 271 of the 1996 Act) and thus gain new sources of revenue.[30] In making

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[28] MCI at 29. See also AT&T at 30.

[29] Northern Pacific Railway v. State of North Dakota, 236 U.S. 585, 598 (1915).

[30] MCI at 30. AT&T at 30, 33 and 36 appears to hold the same view.

such assertions, MCI and AT&T clearly miss an important point made by the Court in Northern Pacific Railway. The Commission cannot establish access rates based on the assumption that rates for other services, such as long distance, will compensate U S WEST and other ILECs for losses incurred in establishing those access rates.[31] This point was made clear by the Supreme Court in Brooks-Scanlon v. Railroad Commission of Louisiana, where the Court held:

> A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage. . . . The plaintiff may be making money from its sawmill and lumber business but it no more can be compelled to spend that than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it.[32]

Nor can the Commission hope or expect that the loss will be recaptured in the intrastate arena. Actual operating costs and investment not recovered in the Commission-imposed rates cannot be shifted to another jurisdiction. This point too has been definitively rendered by the Supreme Court. In Smith v. Illinois Bell Telephone Company,[33] the Supreme Court noted that, at a bare minimum, the power of separating investment and expense between state and federal jurisdictions

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[31] Northern Pacific Railway at 595-96 ("[I]t would be no answer to say that the carrier obtains from its entire intrastate business a return as to the sufficiency of which in the aggregate it is not entitled to complain. Thus, in Lake Shore & Michigan Southern Ry. v. Smith, 173 U.S. 684, the regulation as to the sale of mileage books was condemned as arbitrary without regard to the total income of the carrier. Similarly, in Missouri Pacific Ry. v. Nebraska, 217 U.S. 196, it was held that the carrier could not be required to build mere private connections, and the adequacy of the receipts from its entire business did not enter into the question."). See also Comments of GTE at 82.

[32] 251 U.S. 396, 399 (1920).

[33] 282 U.S. 133, 148-49 (1930).

created independent duties within each jurisdiction to avoid confiscatory ratemaking. In the words of the Court: "The Commission would have . . . no authority to impose intrastate rates, if as such they would be confiscatory, on the theory that the interstate revenue of the company was too small and could be increased to make good the loss."

MCI and AT&T also both argue that no Fifth Amendment taking in the context of a ratemaking proceeding takes place unless the government either invades the property of the ILEC or drives the ILEC into *extremis*.[34] While such a crabbed view of the protection the Constitution gives to private property would seem ludicrous on its face, AT&T and MCI cite Duquesne Light Co. v. Barasch and Federal Power Commission v. Hope Natural Gas for the proposition that a regulator can take as much of a private company's property as it pleases, so long as economic ruin is not the result. Fortunately, these cases stand for no such proposition. In both Duquesne and Hope the challenged regulatory decision actually considered all of the relevant rates and costs and came to a decision which made the carrier whole in the context of the docket itself. These decisions simply hold that a rate docket cannot be picked apart if the overall rate established in the proceeding is sufficient to cover the proper costs and investments at issue in the proceeding.

C. Continued Regulation of Access Rates By The Commission On U S WEST Obligates the Commission to Continue to Guarantee U S WEST a Reasonable Rate of Return For Its Access Services (Notice Section VII)

[34] MCI at 29; AT&T at 39.

Finally, MCI states that regulated utilities are not constitutionally entitled to protection against ordinary market forces.[35] MCI appears to misunderstand the difference between a regulated market and an unregulated market and the Commission's obligations to ILECs under the two different scenarios. It is true that if the access market were completely opened up to competition (i.e., U S WEST were able to set its access charges based on the market), the Commission's regulated market obligation to guarantee U S WEST a right to earn a reasonable rate of return would terminate. However, so long as the Commission continues to regulate U S WEST (i.e., setting or limiting access prices), the Commission retains its obligation and must continue to guarantee that U S WEST has the opportunity to earn a reasonable rate of return, regardless of whether the access market will be open to competition. The Commission may not force U S WEST to conduct business at a loss simply in the name of so-called competition. There is a vast difference between the operation of the full market and the action of the government in limiting the price U S WEST can charge for access service.

IV. THE COMMENTS OF SPRINT CORPORATION PROVIDE A HELPFUL STARTING POINT FOR ANALYSIS (NOTICE SECTION II)

In marked contrast to the comments of AT&T and MCI, Sprint Corporation ("Sprint") has submitted comments which provide a thoughtful and reasonable starting point for analysis. We emphasize that we do not agree with many of the positions Sprint sets forth in its comments -- in many instances our disagreement is vigorous. However, it is apparent that Sprint has, in its Comments, attempted to

[35] MCI at 31.

move the process forward by proposing solutions to very real problems in the area of access reform which are intended as solutions. Because this measured approach commands respect and analysis, we devote this section of these Reply Comments to examining the positives and negatives in Sprint's Comments.

A. Sprint Correctly Characterizes the Key Regulatory Imperatives Which Must Guide the Commission (Notice Sections II, III, IV, V, VI, VII)

Sprint sets forth several principles which must guide the Commission in this docket and other proceedings as the telecommunications marketplace moves toward full competition. These principles are quite similar to the fundamental precepts set forth in U S WEST's initial Comments herein. They are also correct.

- Rate Rebalancing. Sprint observes that ILEC prices are well above TELRIC prices at many levels, both interstate and intrastate.[36] This is because, as Sprint notes, both the interstate and intrastate access structure are laden with subsidies.[37] These subsidies, unlike the pejorative use of the word "subsidies" by AT&T and MCI to connote (falsely) some kind of monopoly profit, are subsidies developed over the decades to fulfill various public interest purposes, most revolving around the universal availability of telephone service.[38] As such, the subsidies which now riddle the telephone pricing structure were motivated by good intentions and no doubt contributed to the current universal service success story. However, with the new Act and the advent of competition, these subsidies

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[36] Sprint at 4-8.

[37] Id.

[38] Id.

must be removed and all prices, not just access and interconnection prices, permitted to move in the direction of economic cost or shifted to universal service support.[39] Indeed, the continued existence of these subsidies is an economic impossibility and also would pose an insurmountable impediment to competition. While Sprint and U S WEST disagree on just what economic cost is and how it should be reflected in prices, U S WEST completely endorses Sprint's conclusion that rate rebalancing, at both the federal and state levels, is imperative to the development of a competitive marketplace, rational rate establishment at the federal and state level, and the essential guaranty against property seizures by the government. To the extent that governmental entities desire to maintain rates below the costs of the providing carrier, such rates must be subsidized on a competitively neutral basis pursuant to Section 254 of the Act.

- Consistency of Subsidies with the Telecommunications Act of 1996. Sprint, noting that "rate rebalancing should not be considered a dirty word,"[40] concludes that the Commission has authority under Sections 253 and 254 of the Act to preempt anticompetitive state pricing rules and policies.[41] U S WEST agrees with this position on the scope of the Commission's authority. While it may seem a bit anomalous for U S WEST to be supporting Commission preemption of pricing decisions by local regulators in light of the position that U S WEST is

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[39] Id.

[40] Id. at 6.

[41] Id. at 8.

now taking before the Eighth Circuit Court of Appeals in Iowa Utilities Board v. FCC,[42] namely, that the Commission does not have the power under the Act to set interconnection prices, our position is in fact completely consistent with the Eighth Circuit argument. State power over local rates must be presumed, whether these rates are for residential service or for interconnection under the Act. However, if a state uses this power over ratemaking in a manner which creates (or continues) a subsidy structure which has the effect of prohibiting development of a competitive telecommunications marketplace, then the Commission must step in under Sections 253(d) and 254 of the Act to ensure that competition is not thwarted by those state pricing decisions and that the universal service portion of the Act are not undermined. Of course, as both Sprint and U S WEST recognize, states have full power to retain below-cost pricing consistent with the Act -- they simply must accomplish such below-cost pricing pursuant to a non-discriminatory universal service plan, not a system of implicit subsidies.

- Carrier Common Line. Sprint notes that loop costs are not traffic sensitive, and that the traffic sensitive carrier common line ("CCL") charge cannot be sustained in a competitive environment. Sprint recommends that the CCL charge be recovered from end users via an increase in the subscriber line charge ("SLC").[43] U S WEST agrees with Sprint's analysis, but has proposed that the CCL could be recovered, at least temporarily, via a flat-rate per-line charge to

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[42] See, e.g., Brief for Petitioners RBOCs and GTE at 21-48 (8th Cir. Nov. 18, 1996).

interexchange carriers ("IXC"). U S WEST has no problem with the Sprint approach -- clearly, proper economic principles would have the cost of the loop recovered from the end user. Similarly, Sprint properly identifies problems which would be faced if the Commission were to attempt to deal with a part of the CCL problem by increasing the CCL cap only on second lines and multi-line businesses.[44] Sprint's recommendation that the SLC be deaveraged on a mandatory basis[45] recognizes the dangers inherent in regulator-mandated price averaging, but does not give sufficient credence to the similar dangers in regulator-mandated price deaveraging. The SLC should be deaveraged, but on a permissive, not a mandated, basis.

- Local Switching. Sprint addresses three aspects of the Notice's proposal for rule modifications dealing with local switching. Where Sprint wants a more rational pricing structure for switching to devolve from above (i.e., via regulatory directive), U S WEST is of the opinion that the optimal method of reaching the agreed-upon end position in these areas is to permit ILECs to move toward these positions on a basis consistent with the individual market needs of each carrier. U S WEST also submits that a "prescriptive" approach to local switching, which could drive local switching prices to TELRIC as a price ceiling, would not be reasonable.

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[43] Sprint at 11.

[44] Id. at 12.

[45] Id. at 17.

* Sprint initially posits that line-side NTS costs should be assessed to the end user.[46] U S WEST supports an ILEC option to establish a flat-rated and usage-based structure charged to IXCs. We agree with Sprint that these costs, to the extent properly attributable to end users, ought to be recovered from end users. As a second-best alternative, however, flat-rated recovery from carriers is preferable to the current system.
* Sprint argues that call set-up costs are too small to warrant a separate charge within local switching.[47] U S WEST has opined that carriers ought to be given the option to establish a call set-up rate element. While U S WEST continues to support the optional approach, Sprint's analysis demonstrates that carriers ought to have the option of not establishing a separate element.
* In the area of peak and off-peak pricing, Sprint supports what is called capacity pricing, whereby an IXC could purchase exclusive access to a facility to allow the IXC to market excess capacity during off-peak periods.[48] U S WEST, on the other hand, supports giving ILECs the option to offer off-peak pricing if it is economical to do so. To the extent that Sprint's proposal amounts to dedication of a finite amount of switching capacity to the exclusive use of an IXC, this would really be more properly akin to a facilities purchase pursuant to the Commission's rules on the

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[46] Id. at 18.

[47] Id. at 19.

[48] Id. at 20.

purchase of unbundled network elements. This type of purchase does not seem to be appropriate as a mandatory part of interstate switched access. On the other hand, Sprint may be describing a volume pricing plan, which U S WEST would support.

- Transport. Sprint addresses many of the suggestions made in the Notice concerning transport.
    - Sprint recommends that entrance facilities and direct trunked transport should be flat rated.[49] U S WEST concurs with this proposal and supports retention of this portion of the existing transport rate structure. Sprint further recommends that as ILECs increase their use of the fiber optic ring architecture, the current mileage-based direct trunked transport rate structure should be modified to reflect per-ring rates instead. Certainly ring deployment and fiber technology will make transport less distance sensitive in densely populated areas in the future and ILECs, if granted the requested structural flexibility, could restructure in this manner.
    - For tandem transport, Sprint contends that the minute-of-use rate structure from the serving wire center to the end office ("unitary structure") should be continued. U S WEST supported elimination of this option to more properly reflect the costs incurred and eliminate the implicit subsidy to small carriers inherent in the current rate structure design. With tandem routed traffic, U S WEST does provision dedicated

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[49] Id. at 21.

trunks for each carrier from its POP to the access tandem, and these dedicated trunks may ride on the same facilities as other carriers' dedicated trunks. Removal of the "unitary structure" option would ensure that tandem users pay on an appropriate flat-rated basis for the dedicated network they use. Sprint also contends that establishing only the "bifurcated structure" would reward the ILECs for the inefficient placement of tandems. U S WEST's network is designed for maximum efficiently, and its access tandems are generally located near the primary users, high concentrations of both carriers, and end users. Sprint suggests several options that the ILECs could undertake, such as determining the number of trunks the IXC should order or imposing minimum monthly usage charges. Both options would create unnecessary administrative burdens for U S WEST, and neither would address the real issue of ensuring that tandem users pay for the network they use.

* Dealing with the court remand in CompTel v. FCC,[50] Sprint contends that transport rates should be based on TELRIC costs after completion of a five-year transition period.[51] U S WEST agrees with Sprint that the CompTel decision does not deprive the Commission of the flexibility to transition toward cost-based transport rates. In fact, under CompTel, the Commission need not adopt cost-based transport rates at all, so long as it explains what it is doing (although we submit that such a failure to do so

[50] 87 F.3d 552 (D.C. Cir. 1996).

would, in the long run, be anticompetitive and contrary to the Act). However, as is discussed further below, U S WEST is concerned that the transition to cost-based rates be completely coincidental with having finally driven all implicit subsidies out of the ILEC rate structures. While a transition to rates which reflect what would be charged in a competitive market is clearly necessary and appropriate, and a five-year transition period may be a reasonable one, the end point of a transition must be a rebalanced rate structure with implicit subsidies replaced by universal service support, not an artificial date.

* Sprint supports using 9000 minutes of use as a surrogate to convert flat-rated elements to minutes-of-use-rated elements (although a simple flat rate may be better).[52] While U S WEST agrees that a conversion factor is appropriate, it does not seem that the same conversion factor would be appropriate for each ILEC. Accordingly, U S WEST submits that each ILEC should be able to support its own unique conversion factor. If an ILEC chose not to develop its own factor, continuation of the 9000 minutes-of-use assumption would be reasonable.

* Sprint contends that ILECs should be required to demonstrate a cost-based relationship between DS1 services and DS3 services.[53] U S WEST submits that the access cost structure should not be based on a mandated

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[51] Sprint at 26.

[52] Id. at 26-27.

[53] Id. at 27-28.

relationship based on capacity. Simply stated, in a fiber world the relationship between cost and capacity for high-capacity transport services will all but disappear. While cost factors are currently taken into account in establishing pricing ratios between DS1 and DS3 services, channel pricing based entirely on cost in this context would be unrealistic -- indeed, it could result in radical deaveraging of a number of service prices in the very near future based on the delivery technology. For example, in some urban areas, a loop delivered over fiber via a digital loop carrier could cost considerably less than a loop delivered over a traditional copper pair. If the same principles were applied to higher-capacity technologies such as OC12 services, price/cost relationships could be dramatic. U S WEST believes that competitive market forces will ultimately bring about the need to completely rethink the pricing methodology for high-capacity services. Sprint's suggestion that regulators undertake the task of establishing high-capacity transport pricing ratios based on channel capacity is not reasonable.

* Sprint recommends that the transport interconnection charge ("TIC") be phased out with a partial transfer of the costs currently in the TIC to the universal service fund support.[54] Sprint recommends that no part of the TIC be transferred to other elements if those elements are already priced at TELRIC, and that the total amount of the annual price cap productivity

[54] Id. at 29.

offset be applied to the TIC over a five-year transition period.[55] At the end of the five-year period, whatever remained of the TIC would simply be written off. To the extent that the TIC represents costs which can be eliminated (i.e., embedded costs), Sprint's approach to the TIC seems reasonable. The U S WEST proposal that the price cap rules be revised to permit use of a single basket with no sub-indices could accomplish this same result. U S WEST's analysis at this time demonstrates that the entire TIC could not, however, be eliminated in five years under this approach. Moreover, as noted in U S WEST's initial Comments, most of the TIC represents the continuing real costs of providing telephone service which have been assigned to the TIC by regulators. These costs will remain as a part of providing service, and elimination of the TIC will have been to no avail if ILECs are not permitted to recover the costs of providing service through either cost-based rates or universal service support. Accordingly, while judicious use of the price cap productivity factor can be used to help solve the TIC problem, it cannot be the entire solution. In the meantime, the bulk bill proposal for collection of the TIC during the transition period (charged only to IXCs) remains the most reasonable manner of recovering the costs now recovered by the TIC. The Sprint five-year transition proposal likewise is reasonable if based on a

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[55] Id.

predicate that the Commission commits itself to eliminating all implicit subsidies by the end of the transition period.

* Sprint recommends that the urban/rural transport averaging rules be modified to permit deaveraging which would allow cost-based pricing for each geographic zone.[56] As a general principle, U S WEST supports the notion of giving ILECs the ability to deaverage where deaveraging makes economic sense. Similarly, U S WEST agrees that mandatory price averaging which operates to give a subsidy to certain classes of customers whose rates are required to be offered below the cost of providing service is anticompetitive and contrary to the Act. However, deaveraging which results in one-way ratcheting (i.e., downward only deaveraging which does not permit recovery of the full-cost amount from the cost-causing customers) can be dangerous. U S WEST submits that the real costs of providing transport should be included in the price of providing transport. The other costs now included in providing transport should be bulk billed and transferred to the SLC or elsewhere over a transition period.

- Market Approach v. Prescriptive Approach. Sprint opposes the Commission's proposed "market" approach to moving access prices toward economic costs, suggesting instead a modified version of the "prescriptive" approach set forth in the Notice, while U S WEST has supported the market approach. In general, Sprint believes that the Commission's market-based approach would result in

[56] Id. at 28-29.

too much pricing flexibility for ILECs before the market is ready to control the use of such flexibility.[57] Sprint suggests that no relaxation of regulation of ILECs is appropriate until ILECs can show evidence of actual "robust" competition.[58] Sprint contends that the Commission cannot rely on market forces to reduce access charges to cost, to a large extent because most near-term entry will take the form of resale, not facilities-based competition.[59] Here U S WEST has some real problems with Sprint's position in several key areas.

* Given the dynamics of the marketplace, if ILECs were required to wait for the actual arrival of "robust competition" before they could receive regulatory flexibility, the game would simply be over. Technology and markets are simply moving too fast to allow such a leisurely approach to ILEC regulatory freedom. By the time "robust competition" has not only arrived but has been documented to regulators, many (if not most) ILECs will in all likelihood have lost the economic ability to utilize their new-found economic freedom. This does not mean that the Commission should deregulate even where regulation remains necessary to protect the public interest. However, the Commission must be cautious to regulate ILECs only where such regulation is demonstrably necessary (as opposed to the converse, which would have regulation continued until it was documented

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[57] Id. at 35, 38-39, 41.

[58] Id. at 36.

[59] Id. at 33. AT&T and MCI have both recently announced plans to compete in local exchange markets primarily as resellers, not as facilities-based competitors.

that such regulation was demonstrably unnecessary). In any such analysis, the Commission must apply its predictive judgment as to what impact the regulation (either new or existing) will actually have on the marketplace. The Commission cannot simply assume that because ILECs have some residual market power all ILEC regulation is therefore presumptively good.

* As part of any analysis of the continued necessity of regulation, it is important to recognize that while parties can debate the extent to which the functional interchangeability of switched access and unbundled network elements will operate to control switched access prices, it is not realistic to argue that such functional interchangeability will not have any impact all. Sprint (along with practically all other commentors) recognizes that the price of unbundled network elements will inevitably affect the price of switched access, and that ultimately competition will drive the prices of functionally equivalent services and functions together. This tendency of the prices of interconnection, unbundled elements, and access to converge, even if it were to be long term in nature (which U S WEST would emphatically deny), must lead to the conclusion that ILECs have far less ability (or incentive) to price access dramatically above the price of unbundled elements than Sprint asserts.
* The market freedoms in the market approach to access reform are not really that dramatic. Geographic deaveraging is part of any regulatory reform and is part of a pro-competitive rate structure even in the absence

of any robust competition. Volume and term discounts are common market tools which reflect activity in a competitive market which is quite normal. The ability to contract price in response to RFPs is likewise not dramatic -- AT&T was given a type of contract pricing authority under the Tariff 12 orders without any demonstration of robust competition at all.[60] In fact, the Commission's Tariff 12 decisions were predicated on the assumption that AT&T retained significant market power -- so much so that some market freedoms granted to AT&T in the Tariff 12 decisions were withdrawn in the decision declaring AT&T to be a non-dominant carrier in many of its services.[61] In other words, even if the development of competition and the availability of interconnection and unbundled network elements as substitutes for access were not sure to act as a significant market check on access prices, the phase-one market freedoms are not particularly dramatic and are eminently supportable.

- TELRIC Pricing of Access. Sprint predicates a good deal of its analysis on the assumption that a proper pricing model for access can be predicated on the Commission's TELRIC costing rules.[62] It is true that in a competitive market prices of services tend to be driven toward economic costs. U S WEST also agrees that the Commission's TELRIC model does a reasonable job of predicting

[60] See U S WEST Comments, filed herein Jan. 29, 1997 at 23 n.27.

[61] See In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, 11 FCC Rcd. 3271 (1995).

[62] E.g., Sprint at iii, 8.

forward-looking costs -- by including such necessary elements as recognition of the location of existing wire centers, requiring economic depreciation lives and a reasonable allocation of joint and common costs, and requiring a risk adjusted cost of capital.[63] But accurately predicting forward-looking economic costs is a far cry from using those costs to set prices, especially price ceilings. As noted in U S WEST's initial Comments, particularly in the attached affidavit of Robert Harris and Dennis Yao, while market forces drive prices in the direction of forward-looking economic costs, market forces do not result in prices set precisely at those calculated cost levels. The reason is obvious -- in a competitive market, competitors invest in new technology and services to gain a competitive advantage, and a competitive advantage by definition permits the charging of prices over economic cost levels. A market where prices were set at TELRIC cost levels would be an extraordinarily stagnant one, marked by very little investment and innovation, and characterized instead by competitors who sought to obtain their competitive advantage via marketing gimmicks and brand-name recognition.[64] While U S WEST agrees that competition will drive everyone's prices toward economic cost levels, competition will not drive everyone's prices to a level marked by economic costs as a price ceiling. The Commission should not try to do so either. The market approach to access rate

[63] We must be very careful in defining just what TELRIC is. AT&T and MCI have sponsored something called the "Hatfield Model" which pretends to predict TELRIC, but which actually posits network costs which are utterly biased and fanciful.

[64] See U S WEST Comments, CC Docket No. 96-98, filed May 16, 1996, Exhibit 1 at 13-15. Professor Kahn elaborates on this notion in Attachment A.

rebalancing will permit access prices to fall to reasonable market levels, rather than being pushed to levels lower than would be caused by any rational competitive marketplace.

- Depreciation Reserve Deficiency. Sprint recognizes the existence of a reserve deficiency, but suggests that it is "essentially a hopeless task" to try to sort out the actually reserve deficiency from inefficiencies it feels are the almost certain legacy of the days of monopoly service.[65] Sprint's approach is to give the ILECs a certain amount of time to deal with the difference between cost-based access and the existing interstate costs and not to worry about the source or disposition of the excess costs. U S WEST, on the other hand, submits that it is entitled to the opportunity to recover all of its embedded costs, and that it can identify its reserve deficiency with sufficient precision to permit an orderly amortization of the deficiency amount (interstate and intrastate). While still short on details, Sprint's approach deserves some more consideration. If an overall regulatory matrix can be developed which gives U S WEST the realistic opportunity to recover its embedded costs over a time certain, this approach could be more productive and more conducive to economic efficiency than a more specific regulatory solution. U S WEST will attempt to work with the industry to determine if such a solution is possible. However, no matter what the solution to timely recovery of embedded costs, that solution must include a comprehensive rate rebalancing, including separations reform, which properly

[65] Sprint at 55.

assigns actual and continuing costs to cost causers.[66] Otherwise the revenues which support the real costs of providing service could be "phased out," with the consequence that service itself could be affected adversely.

V. UNIVERSAL SERVICE IS NOT STRICTLY AN INTERSTATE ISSUE (Notice Section VII)

Many commentors assume that the universal service fund (or "USF") resulting from the ongoing rulemaking at the Commission will result in an explicit subsidy which is limited entirely to interstate subsidy elimination.[67] U S WEST submits that this is not a realistic assumption, especially under the approach the Joint Board has taken in its Recommended Decision.[68] The Joint Board has recommended that the federal universal service support mechanisms for schools, libraries and rural health care providers be funded by carriers who provide interstate service -- — but that each carrier's contribution to the fund be based on that carrier's total revenues, interstate plus intrastate.[69] Under these circumstances, limiting the applicability of the USF solely to interstate subsidies would be both suboptimal and of dubious legality. The approach suggested by U S WEST -- applying the Commission-controlled universal fund to intrastate as well as interstate services based on a total-cost benchmark, with states being required to use their own universal service funds to subsidize rates at price levels

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[66] Or, of course, universal service support.

[67] In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45.

[68] In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, FCC 96J-3, rel. Nov. 8, 1996.

below the benchmark -- is substantially superior to a strictly interstate fund. We recognize that this issue will be decided in the context of the universal service docket. However, in the context of this docket, it is important for the Commission to keep in mind that the assumption by various commentors that the interstate universal service fund will be applied entirely to interstate subsidies is unwarranted.

VI. ESP EXEMPTION REFORM REMAINS CRITICAL (NOTICE SECTION X)

There was considerable consensus to the effect that the enhanced service provider ("ESP") exemption ought to be fixed, at least (as U S WEST has suggested) once access prices are rationalized.[70] However, and not surprisingly, a number of entities whose operations are subsidized by the ESP exemption continue to argue for its continuation, claiming primarily that the services they use are not equivalent to the services purchased by interexchange carriers.[71] The primary difficulty with this argument is that it is irrelevant. The ESP exemption is a jurisdictional misassignment, not a usage question. The ESP exemption arises out of the fact that ESPs do not pay for a share of local exchange switching facilities assigned to the interstate jurisdiction. It has nothing to do with usage or service purchased. The ESP exemption was meant to be a temporary subsidy to ESPs to help them avoid rate shock in the aftermath of divestiture. The vigor with which some ESPs

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[69] Id. at ¶ 817.

[70] See, e.g., Southwestern Bell Telephone Company at 19-20; Pacific Telesis Group at 78-80.

[71] See, e.g., America Online, Inc. at 4-7; Microsoft Corporation at 3-4; National Cable Television Association at 4; CompuServe Incorporated at 4-16.